

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51759; File No. SR-Phlx-2004-91)

May 27, 2005

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 Thereto to Establish a Directed Order Process for Orders Delivered to the Phlx Via AUTOM

I. Introduction

On December 9, 2004, the Philadelphia Stock Exchange, Inc. (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² to establish a directed order process for orders delivered to the Exchange via the Automated Options Market (“AUTOM”). The proposed rule change was published for comment in the Federal Register on December 22, 2004.³ The Commission received three comment letters on the proposal.⁴ On January 18, 2005, the Phlx sent a response to the comment letters.⁵

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 50856 (December 14, 2004), 69 FR 76817.

⁴ See letter from Michael J. Simon, General Counsel and Secretary, International Securities Exchange, Inc. (“ISE”), to Jonathan G. Katz, Secretary, Commission, dated January 13, 2005 (“ISE Letter”); letter from Philip D. DeFeo, Chairman and Chief Executive Officer, Pacific Exchange, Inc. (“PCX”), to Jonathan G. Katz, Secretary, Commission, dated March 22, 2005 (“PCX Letter”); and letter from Matthew Hinerfeld, Managing Director and Deputy General Counsel, Citadel Investment Group, L.L.C., on behalf of Citadel Derivatives Group LLC (“Citadel”), to Jonathan G. Katz, Secretary, Commission, dated April 6, 2005 (“Citadel Letter”).

⁵ See letter from Richard S. Rudolph, Director and Counsel, Phlx, to Jonathan G. Katz, Secretary, Commission, dated January 18, 2005 (“Phlx Letter”).

On April 27, 2005, the Phlx filed Amendment No. 1 to the proposed rule change.⁶ This order approves the proposed rule change and simultaneously provides notice of filing and grants accelerated approval of Amendment No. 1.

II. Description of the Proposed Rule Change

The Phlx proposes to establish, for a one-year pilot period, rules that permit Exchange specialists, Streaming Quote Traders (“SQTs”), and Remote Streaming Quote Traders (“RSQTs”) assigned in options trading on the Phlx XL system (“Streaming Quote Options”) to receive directed orders. The Phlx proposes to define the term “Directed Order” to mean any customer order to buy or sell that has been directed to a particular specialist, SQT, or RSQT by an Order Flow Provider (“OFP”).⁷ The Phlx also proposes to establish a trade algorithm for electronically executed and allocated trades involving Directed Orders, which would provide a participation guarantee to the Directed Specialist, SQT, or RSQT (collectively “Phlx directed participants”).

To qualify as a Directed Order, an order must be delivered to the Exchange via AUTOM. AUTOM currently functions to provide automatic executions in Streaming Quote Options only when the Exchange’s disseminated bid or offer is the National Best Bid or Offer (“NBBO”). Therefore, to participate in automatic executions of Directed Orders, Phlx directed participants would be required to be quoting the NBBO at the time the Directed Order is received.

Currently, an SQT or RSQT must quote continuous, two-sided markets in not less than 60% of the series in each Streaming Quote Option traded on Phlx XL in which such SQT or

⁶ Amendment No. 1 added language to clarify the application of the allocation algorithm and to note that Phlx Rule 707, Just and Equitable Principles of Trade, would prohibit coordinated actions between a Phlx directed participant and an OFP involving Directed Orders.

⁷ The term Order Flow Provider under proposed Phlx Rule 1080(l)(i)(B) would mean any member or member organization that submits, as agent, customer orders to the Exchange.

RSQT is assigned. A specialist must quote continuous, two-sided markets in not less than 100% of the series in each Streaming Quote Option in which such specialist is assigned.⁸ Under the proposal, like specialists, Directed SQTs or RSQTs would be required to quote continuous, two-sided markets in not less than 100% of the series in each Streaming Quote Option in which they receive Directed Orders.

Directed Orders would first be allocated to customer limit orders resting on the limit order book at the execution price. Any remaining contracts would be allocated as follows:

- If the specialist were directed an order, it would be allocated a number of contracts that is the greater of: (1) its size pro rata share; (2) the Enhanced Specialist Participation;⁹ or (3) 40% of the contracts to be allocated.
- If an SQT or RSQT were directed an order, it would be allocated a number of contracts that is the greater of: (1) its size pro rata share; or (2) 40% of the contracts to be allocated.
- After a specialist, SQT, or RSQT is allocated contracts, other market makers quoting at the disseminated price, and non-SQT Registered Options Traders (“ROTs”) that have placed limit orders on the limit order book via electronic interface would be allocated their size pro rata of the remaining contracts.
- If any contracts still remain, off-floor broker-dealers that have placed limit orders on the limit order book that represent the Exchange’s disseminated price would be allocated contracts on a size pro rata basis.
- Finally, if the Directed Order is for a size that is greater than the Exchange’s disseminated size, remaining contracts would be allocated manually in accordance

⁸ See Phlx Rule 1014(b)(ii)(B).

⁹ See Phlx Rule 1014(g)(ii).

with Phlx Rule 1014(g)(v), which sets forth the rules and contract allocation algorithm for trades that are executed in the trading crowd. A market maker directed an order would not be entitled to receive a number of contracts that is greater than the size associated with its quotation, nor would a ROT or off-floor broker-dealer be entitled to receive a number of contracts that is greater than the size associated with its limit order.

The allocation algorithm would apply to Directed Orders in lieu of the current allocation algorithm applicable to orders other than Directed Orders contained in Exchange Rule 1014(g)(vii). Specialists that are not Directed Specialists participating in trades involving a Directed SQT or a Directed RSQT would be entitled to receive a number of contracts as specified in proposed rule 1014(g)(viii), and would not be entitled to receive an Enhanced Specialist Participation on the remaining contracts.

III. Discussion and Commission Findings

The Commission has reviewed carefully the proposed rule change, comment letters, and the Phlx's response and finds that the proposed rule change is consistent with the requirements of Section 6 of the Act¹⁰ and the rules and regulations thereunder applicable to a national securities exchange¹¹ and, in particular, the requirements of Section 6(b)(5) of the Act.¹² Section 6(b)(5) requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles

¹⁰ 15 U.S.C. 78f.

¹¹ In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹² 15 U.S.C. 78f(b)(5).

of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission received three comment letters regarding the proposal, all of which opposed the proposal.¹³ The commenters criticized the proposal because they believe it would allow a Phlx directed participant a guarantee based solely on its relationships with order entry firms rather than on such Phlx directed participant's obligations.¹⁴ The commenters assert that the proposal would reward a Phlx directed participant for its payment for order flow arrangements rather than the quality of its quotes, and therefore the proposal would have a negative impact on price competition.¹⁵ In addition, two commenters note that the proposal would not limit the allocation entitlement to specialists, but extend it to SQTs and RSQTs, which have fewer obligations to the market.¹⁶ Two commenters also believed that the proposal did not address the possibility of coordinated actions between a directed market maker and an OFP.¹⁷

The Commission has previously approved rules that guarantee a Phlx specialist a portion of each order when the specialist's quote is equal to the NBBO.¹⁸ The Commission has closely scrutinized exchange rule proposals to adopt or amend a specialist guarantee where the

¹³ See supra note 4.

¹⁴ See, e.g., ISE Letter, supra note 4 at 1-2; PCX Letter, supra note 4 at 1-2; Citadel Letter, supra note 4 at 2.

¹⁵ Id.

¹⁶ ISE Letter ("The Phlx proposal is not limited to specialist[s], and the Phlx does not attempt to justify this proposal other than as a way to reward market makers that attract order-flow to the Phlx."), supra note 4 at 1, 3-4; Citadel Letter, supra note 4 at 2.

¹⁷ ISE Letter, supra note 4 at 3; PCX Letter, supra note 4 at 2.

¹⁸ See Securities Exchange Act Release No. 34606 (August 26, 1994), 59 FR 45741 (September 2, 1994) (SR-Phlx-94-12) (order approving the enhanced specialist participation in Phlx Rule 1014(g)(ii) for a one-year pilot basis); see Securities Exchange Act Release No. 41588 (July 1, 1999), 64 FR 37185 (July 9, 1999) (SR-Phlx-98-56) (order approving the enhanced specialist participation in Phlx Rule 1014(g)(ii) on a permanent basis).

percentage of specialist participation would rise to a level that could have a material adverse impact on quote competition within a particular exchange.¹⁹ Because the proposal would not increase the overall percentage of an order that is guaranteed to the specialist beyond the currently acceptable threshold, but instead would allow SQTs and RSQTs to share in that guarantee, the Commission does not believe that the proposal will negatively impact quote competition on the Phlx. Under the proposal, the remaining portion of each order will still be allocated based on the competitive bidding of market participants.

In addition, a Phlx directed participant will have to be quoting at the NBBO at the time the order is received to capitalize on the guarantee. The Commission believes it is critical that the Phlx directed participant cannot step up and match the NBBO after it receives an order, but must be publicly quoting at that price when the order is received. In this regard, the Phlx's proposal prohibits from notifying a Phlx directed participant regarding its intention to submit a Directed Order so that such Phlx directed participant could change its quotation to match the NBBO immediately prior to submission of the preferenced order, and then fade its quote. In response to commenters' concerns that its proposal failed to protect against coordinated actions between a Phlx directed participant and an OFP, the Phlx stated it believes its Rule 707, Just and Equitable Principles of Trade, already provides the necessary protections against that type of conduct, and will proactively conduct surveillance for, and enforce against, such violations.²⁰

One commenter states that specialists currently receive participation entitlements based on their obligations to the market. The commenter believes that the proposal, by allowing any

¹⁹ See Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48788 (August 9, 2000).

²⁰ See Amendment No. 1; letter from Edith Hallahan, Deputy General Counsel, and Edward Deitzel, Vice President, Phlx, to John Roeser, Assistant Director, Division of Market Regulation, Commission, dated May 26, 2005.

directed market maker quoting at the NBBO to receive a guaranteed percentage of an order without in turn increasing the market maker's obligations to the market, would "eliminate the incentive to be a specialist, thereby potentially leaving the obligations of the specialist to the market unfulfilled."²¹ The Commission does not believe that the proposal will result in the role of the specialist going unfulfilled, and notes that it recently approved an options exchange without specialists.²² Moreover, specialists' obligations to the market have been reduced through other changes, including greater automation of functions previously handled manually by the specialist. While this proposal may reduce the incentive to be a specialist, the Commission does not believe that makes the proposal inconsistent with the Act. Finally, the Commission notes that Phlx specialists and Directed SQTs and RSQTs have greater quoting obligations than other Phlx market makers who cannot be Phlx directed participants. Specifically, Phlx specialists must submit continuous, two-sided quotations in 100% of the series of options in which it is assigned,²³ and a Directed SQTs or RSQTs must submit continuous, two-sided quotations in 100% of the series of options in which it receives Directed Orders. To receive an allocation under this rule filing, the Phlx directed participant must be quoting at the NBBO for the size of the allocation received.

Two commenters believe that the proposal is similar to facilitation guarantees and other directed order programs approved by the Commission.²⁴ However, unlike those programs, the

²¹ Citadel Letter, supra note 4 at 2.

²² See Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (SR-BSE-2002-15) (order approving trading rules for the Boston Options Exchange Facility).

²³ See Phlx Rule 1014(b)(ii)(B).

²⁴ ISE Letter ("There is no distinction between a broker 'facilitating' an order and a broker directing an order to a particular market maker for execution..."), supra note 4 at 3-4; PCX Letter, supra note 4 at 2.

commenters criticize that the instant proposal does not include certain protections for customers, such as providing the opportunity for price improvement, or limiting the program to a minimum number of contracts.²⁵

The Commission believes that the proposal is more akin to current participation entitlements, for specialists, than the facilitation guarantee programs and other directed order programs cited by the commenters. Unlike exchange facilitation guarantee programs,²⁶ under the proposal, the Phlx directed participant would not be eligible for a participation entitlement unless it is publicly quoting at the NBBO at the time an order is received. Instead of changing its facilitation program rules, this proposal allows Phlx directed participants to share in the participation entitlement currently available only for specialists. The Commission believes this reallocation is consistent with the Act and will not affect the incentives of the trading crowd to compete aggressively for orders based on price.

The Commission emphasizes that approval of this proposal does not affect a broker-dealer's duty of best execution. A broker-dealer has a legal duty to seek to obtain best execution of customer orders, and any decision to preference a particular specialist, SQT, or RSQT must be consistent with this duty.²⁷ A broker-dealer's duty of best execution derives from common law

²⁵ ISE Letter, supra note 4 at 3-4; PCX Letter, supra note 4 at 2.

²⁶ See CBOE Rule 6.74(d); ISE Rule 716(d); Pacific Exchange, Inc. Rule 6.47(b); American Stock Exchange, Inc. Rule 950(d), Commentary .02(d); and Philadelphia Stock Exchange, Inc. Rule 1064, Commentary .02.

²⁷ See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 269-70, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998); Certain Market Making Activities on Nasdaq, Securities Exchange Act Release No. 40900 (Jan. 11, 1999) (settled case) (citing Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971); Arleen Hughes, 27 SEC 629, 636 (1948), aff'd sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949)). See also Order Execution Obligations, Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) ("Order Handling Rules Release").

agency principles and fiduciary obligations, and is incorporated in SRO rules and, through judicial and Commission decisions, the antifraud provisions of the federal securities laws.²⁸

The duty of best execution requires broker-dealers to execute customers' trades at the most favorable terms reasonably available under the circumstances, i.e., at the best reasonably available price.²⁹ The duty of best execution requires broker-dealers to periodically assess the quality of competing markets to assure that order flow is directed to the markets providing the most beneficial terms for their customer orders.³⁰ Broker-dealers must examine their procedures

²⁸ Order Handling Rules Release, 61 FR at 48322. See also Newton, 135 F.3d at 270. Failure to satisfy the duty of best execution can constitute fraud because a broker-dealer, in agreeing to execute a customer's order, makes an implied representation that it will execute it in a manner that maximizes the customer's economic gain in the transaction. See Newton, 135 F.3d at 273 (“[T]he basis for the duty of best execution is the mutual understanding that the client is engaging in the trade – and retaining the services of the broker as his agent – solely for the purpose of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal.”); Marc N. Geman, Securities Exchange Act Release No. 43963 (Feb. 14, 2001) (citing Newton, but concluding that respondent fulfilled his duty of best execution). See also Payment for Order Flow, Securities Exchange Act Release No. 34902 (Oct. 27, 1994), 59 FR 55006, 55009 (Nov. 2, 1994) (“Payment for Order Flow Final Rules”). If the broker-dealer intends not to act in a manner that maximizes the customer's benefit when he accepts the order and does not disclose this to the customer, the broker-dealer's implied representation is false. See Newton, 135 F.3d at 273-274.

²⁹ Newton, 135 F.3d at 270. Newton also noted certain factors relevant to best execution - order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. Id. at 270 n. 2 (citing Payment for Order Flow, Securities Exchange Act Release No. 33026 (Oct. 6, 1993), 58 FR 52934, 52937-38 (Oct. 13, 1993) (Proposed Rules)). See In re E.F. Hutton & Co. (“Manning”), Securities Exchange Act Release No. 25887 (July 6, 1988). See also Payment for Order Flow Final Rules, 59 FR at 55008-55009.

³⁰ Order Handling Rules Release, 61 FR at 48322-48333 (“In conducting the requisite evaluation of its internal order handling procedures, a broker-dealer must regularly and rigorously examine execution quality likely to be obtained from different markets or market makers trading a security.”). See also Newton, 135 F.3d at 271; Market 2000: An Examination of Current Equity Market Developments V-4 (SEC Division of Market Regulation January 1994) (“Without specific instructions from a customer, however, a broker-dealer should periodically assess the quality of competing markets to ensure that

for seeking to obtain best execution in light of market and technology changes and modify those practices if necessary to enable their customers to obtain the best reasonably available prices.³¹ In doing so, broker-dealers must take into account price improvement opportunities, and whether different markets may be more suitable for different types of orders or particular securities.³²

The Commission notes that the proposed rule change would be implemented on a pilot basis for one year. During this time, the Commission intends to evaluate the impact of the proposal on the options markets to determine whether it would be beneficial to customers and to the options markets as a whole before approving any request for permanent approval of the pilot program.

For these reasons, the Commission believes that the proposal is consistent with the requirements of Section 6(b)(5) of the Act,³³ and will not jeopardize market integrity or the incentive for market participants to post competitive quotes.³⁴

its order flow is directed to markets providing the most advantageous terms for the customer's order."); Payment for Order Flow Final Rules, 59 FR at 55009.

³¹ Order Handling Rules, 61 FR at 48323.

³² Order Handling Rules, 61 FR at 48323. For example, in connection with orders that are to be executed at a market opening price, "[b]roker-dealers are subject to a best execution duty in executing customer orders at the opening, and should take into account the alternative methods in determining how to obtain best execution for their customer orders." Disclosure of Order Execution and Routing Practices, Securities Exchange Act Release No. 43590 (Nov. 17, 2000), 65 FR 75414, 75422 (Dec. 1, 2000) (adopting new Exchange Act Rules 11Ac1-5 and 11Ac1-6 and noting that alternative methods offered by some Nasdaq market centers for pre-open orders included the mid-point of the spread or at the bid or offer).

³³ 15 U.S.C. 78f(b)(5).

³⁴ Approval of this proposal is in no way an endorsement of payment for order flow by the Commission.

IV. Accelerated Approval of Amendment No. 1

Pursuant to Section 19(b)(2) of the Act,³⁵ the Commission may not approve any proposed rule change, or amendment thereto, prior to the 30th day after the date of publication of notice of the filing thereof, unless the Commission finds good cause for so doing and publishes its reasons for so finding. The Commission hereby finds good cause for approving Amendment No. 1 to the proposal, prior to the 30th day after publishing notice of Amendment No. 1 in the Federal Register.

The Commission believes that it has received and fully considered meaningful comments with respect to the proposal, and that Amendment No. 1 does not raise any new regulatory issues that warrant further delay. In Amendment No. 1, the Exchange added language to clarify the application of the allocation algorithm. In addition, Amendment No. 1 added language to note that Phlx Rule 707, Just and Equitable Principles of Trade, prohibits coordinated actions between the Phlx directed participant and the OFP involving Directed Orders. The Commission believes that the addition of the language is appropriate to clarify the proposed Directed Order process.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment No. 1 is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-Phlx-2004-91 on the subject line.

³⁵ 15 U.S.C. 78s(b)(2).

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-Phlx-2004-91. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the Phlx. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available. All submissions should refer to File Number SR-Phlx-2004-91 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁶ that the

³⁶ 15 U.S.C. 78s(b)(2).

proposed rule change (SR-Phlx-2004-91) be, and hereby is, approved, and that Amendment No. 1 to the proposed rule change be, and hereby is, approved on an accelerated basis, for a pilot period to expire on May 27, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁷

Margaret H. McFarland
Deputy Secretary

³⁷ 17 CFR 200.30-3(a)(12).